IDAHO OUTLOOK

NEWS OF IDAHO'S ECONOMY AND BUDGET

STATE OF IDAHO DIVISION OF FINANCIAL MANAGEMENT FEBRUARY 2000 VOLUME XX NO. 8

An Interesting Rule. Have you ever wanted to be an economist, or a least sound like one? Well, here's a shortcut. The next time someone asks, "What do you think interest rates will do?" you'll no longer have to resort to the pat response of "they may go up or they may go down." Thanks to the work of Stanford University economics professor John B. Taylor, you'll have an intelligent answer.

Monetary Policy Rule

Inflation Rate (percent)	*% Deviation of Real GDP from Potential GDP* -2	0	2
0	0.5	1	2
2	3	4	5
4	6	7	8
6	9	10	11
8	12	13	14

Source: Dr. John B. Taylor

Dr. Taylor's findings are summarized in the accompanying table, and show the expected federal funds rate given the current levels of inflation and the performance of real GDP. The table is easy to use. The example shaded in gray illustrates that if inflation is running at 2% and real GDP is at its potential (0% deviation), then the federal funds rate is expected to be 4%. If real GDP is growing faster than its potential, the Federal Reserve will be more aggressive at any level of inflation. For example, the federal funds rate should be 5% when inflation is still at 2% but real GDP growth is 2 percent above its potential. If real GDP growth is below its potential, the Federal Reserve will be less aggressive.

The rule's value depends on how well it predicts actual Federal Reserve behavior. A study prepared by economists at the Federal Reserve Bank of San Francisco found that Taylor's Rule "does a reasonable job of describing the actual funds rate under Chairman Greenspan." So why does this rule work? Dr. Taylor believes the Federal Reserve follows a set of rules to achieve optimal monetary policy. By observing the Federal Reserve's behavior, one can get a sense of these rules. For example, he assumes the Federal Reserve would like an inflation rate of around 2% and a federal funds rate of around 4%. Data show these assumptions to be reasonable. However, the formula has been less successful in describing the actions of Arthur Burns and Paul Volcker.

For example, rates based on Taylor's Rule are higher than the actual interest rates during the chairmanship of Arthur Burns in 1970-78. Interestingly, some feel the Federal Reserve was too lax during this period and this led to the inflation run up in the late 1970s and early 1980s, which is what Taylor's Rule also seems to suggest. The opposite occurred during the tenure of Paul Volcker. The data show the federal funds rate was higher than the Taylor Rule rate, meaning the Federal Reserve was more aggressively fighting inflation than would have been expected. However, this tight policy does not seem unreasonable, given the need to reduce that period's runaway inflation.

Over the years, attempts have been made to improve on Dr. Taylor's Rule. While these new models have experienced various degrees of success, the usefulness of his original rule remains unchallenged. Now if the good doctor could just come up with a simple way to pick winning stocks…

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January's Sales Tax weakness is puzzling in view of widespread national reports that December produced the best holiday shopping season in a decade. On a year-to-date basis, the Idaho Sales Tax is now $0.6 million lower than expected.

The Product Taxes were exactly on target for the third consecutive month, but the Miscellaneous revenue category was ahead of the target by a wide margin for the second straight month. January's strong Miscellaneous collections were dominated by Treasurer's interest earnings. An unusually high volume of investments matured in January, leading to almost $3 million more in interest earnings than were expected. (Note: interest earnings are recorded on a cash basis, leading to wide swings in the timing of interest earnings that depend on the maturity date of specific investment instruments.) Another factor behind January's strength was several fund transfers that are reflected in the overall FY 2000 revenue forecast, but were not explicitly included in January's predicted collections. The Miscellaneous category now stands $7.3 million above the predicted amount for the year to date.

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General Fund Update

As of January 31, 2000

Revenue Source	$ Millions FY00 Executive Estimate[3]	DFM Predicted to Date	Actual Accrued to Date
Individual Income Tax	892.2	511.6	522.4
Corporate Income Tax	99.3	53.2	56.9
Sales Tax	617.6	379.8	379.2
Product Taxes[1]	15.8	9.5	9.5
Miscellaneous	83.4	38.9	46.2
TOTAL GENERAL FUND[2]	**1,708.4**	**993.0**	**1,014.2**

1 Product Taxes include beer, wine, liquor, and cigarette taxes
2 May not total due to rounding
3 Revised Estimate as of January 2000

General Fund revenues made an unusually strong gain in January, exceeding the predicted level by $16.2 million. The Individual Income Tax is the category most responsible for this surge, but it is unclear at this point whether the $13.1 million excess Individual Income Tax collected in January is a real gain or merely an acceleration of revenues normally received in April. Another part of January's gain came from the Miscellaneous revenue category. The Miscellaneous boost is believed to be entirely a matter of the timing of collections (i.e., it does not represent a net gain relative to the full fiscal year's forecast).

The Individual Income Tax excess of $13.1 million was dominated by filing collections that were $12.2 million higher than expected in January. Instead of the 9.8% growth that was predicted, filing collections grew by 42% in January. Strong filing collections are typical at the end of the calendar year as taxpayers voluntarily prepay their estimated state income tax in order to claim it as a federal deduction. A small part of January's surge can be explained by year-end timing (specifically, banks were open the last day of December but State of Idaho offices were closed). April's receipts will determine whether January's collections were a hint of things to come (that is, exceptionally strong income tax collections) or an acceleration of revenue. Overall, the Individual Income Tax now stands $10.8 million ahead of expectations.

The Corporate Income Tax was slightly ($1.2 million) ahead of the predicted amount for January. This is the sixth consecutive month of better-than-expected revenue collections, with the year-to-date excess now at $3.7 million.

The Sales Tax in January produced the second shortfall of the fiscal year. January collections represent December sales activity, and the $1.7 million shortage for the month brings the year-to-date balance to a level that is $0.6 million lower than expected.

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